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One of the most fascinating (and dangerous) things about this market is the utter lack of recognition, lack of even a hint, that we could be on the edge of a primary bear market. I don't think I've ever seen anything like it. But I guess it's understandable. After all, the public has been inculcated with the "buy the dip" philosophy for so long, they have been told about "growth as far as the eye can see" for so long, that they cannot even envision a major, crushing bear market.

Richard Russell, *Dow Theory Letters*, Aug. 11, 1999

Ominous Auguries

While we cannot pronounce the end of the great U.S. stock market bubble with confidence, the danger signals in the financial system are rapidly accumulating: the broad rise in market interest rates, the weak dollar, the steep plunge of Internet stocks, the dramatic widening of spreads and serious dislocations in the derivatives market. We describe and analyze these critical development in detail.

Once more, this letter delves into the conundrum of the U.S. "new paradigm" economy. How much of it is true, how much of it is just statistical hoax? We bring an excerpt from a recently published study by Prof. Robert J. Gordon of Northwestern University, one of America's top authorities on the subject. It fully corroborates our alarming findings exposing the postulated productivity acceleration across the U.S. economy as a statistical hoax. The productivity hoax essentially explains the rotten profit performance.

Spreading weakness in the U.S. stock market continues to be obscured by the strength in the Dow and the S&P 500. While these bellwethers set their July highs, the accelerating damage in other key technical measures, indicating deteriorating market liquidity, is inescapable.

CHASING MYTHS

When the Commerce Department recently released the GDP figures for the second quarter, the world media and information services focused on just two numbers: an annualized rise in real GDP of 2.3% and an increase in labor costs by 1.1%.

Nobody mentioned the most relevant feature of all. Of the recorded GDP growth, measured in chained dollars, no less than 93% had come from the computer makers, accounting for $41.1 billion of $44 billion total GDP growth. Actual expenditures on computers in current dollars, however, increased by the trifling sum of $3.9 billion. Stripped of the computer contribution, the booming U.S. economy would have virtually stagnated.

Looking at the GDP accounts in current dollars, the most striking aspect continues to pertain to the consumer: With an increase in personal disposable income in the second quarter by $75.2 billion, personal outlays swelled at the same time by $100.4 billion. Though hard to believe, personal dissaving jumped to a new negative high of $70.7 billion.

THE KEY MEASURE: PRODUCTIVITY GROWTH

As we have often enough stressed, the U.S. financial boom of the 1990s has been driven by two propellants: unprecedented credit excesses and inordinate hype about miracles happening to the U.S. economy through high tech and a managerial revolution. It became the overriding perception that in the wake of these two

developments a virtually "new economy" has been created, explaining America's record-breaking economic expansion, the recent surge in productivity, a profit boom, the vanishing of unemployment and the death of inflation. These phenomenal economic enhancements, in the consensus view, perfectly justify the all-time record-breaking valuations of corporate stocks.

Though most people have never taken these boasts at face value, it has nevertheless been widely accepted that there must essentially be some truth to this exultant bragging about the U.S. economy's awesome performance. Maybe it is a bit less than a miracle, but how could all these great achievements and the amazing stock market boom have occurred if their had not been some extraordinary improvements in the economy's structure?

The answer, though hard to believe, is this: The American "productivity miracle" of the 1990s is pure statistical fiction. These statistics have grossly distorted the perception of the boom—making it appear exceedingly healthy. There has been a boom, yes, just not the sound boom claimed by the bulls: in productivity, profits and manufacturing investment, except computers. It has been, instead, in consumer spending, housing, building for consumer services (retail, casinos, football stadiums, movie cinemas and restaurants), office buildings and, importantly, telecommunications. Looking at the exploding trade deficit, it is clear that the domestic spending excess is flooding abroad.

A second crucial point to keep in mind whenever talking about productivity growth is that capital formation, measured by the net growth of the capital stock through new investment in plant and equipment, is the most important single source of productivity growth. Throughout the postwar period, the United States has had the lowest rate of capital formation and the lowest rate of productivity growth among the industrial countries. Has that changed? No.

First a bit of history. Labor productivity growth in the United States began to decline during the last half of the 1960s. This decline occurred in two stages: the first extended from about 1965 through 1972; the second has continued until 1995. Labor productivity growth—measured as increase in output per work hour—is usually estimated to have run at an annual rate of about 3.1% in America from the end to World War II to 1965. Then, during the 1965-1972 slowdown, it fell to 2%-2.5% a year. After a temporary fall between 1973-79 to a low of 0.3%, it then hovered around 1% per annum until 1995.

THE MYTH OF THE 1980s...

When Ronald Reagan came to power, his policy crew trumpeted that they would improve the "supply side" of the economy. Keynesian "demand side" economics was condemned as the source of all troubles, from inflation to unemployment. Tax cuts, by stimulating work effort and by directing available savings to investors, would launch a great burst of capital formation in building new factories and developing more supply capacity.

Ironically, nothing of that materialized. John Maynard Keynes got the last laugh. Capital formation declined, and productivity growth failed to improve at all. What was the reason? For explication, we quote from the 74th annual report, Dec. 31, 1988, of the Federal Reserve Bank of New York:

> *Real net business investment in relation to GNP has been substantially weaker during the last six years than over the earlier period (the 1970s), with the manufacturing investment component averaging only about one-tenth of 1 percent of GNP. As a result of the slowdown in capital formation, the amount of capital per worker in both the whole economy and the manufacturing sector has been essentially flat since 1982...If, for example, capital per worker in the manufacturing sector had continued to advance at the trend rate of the 1968-82 period, it would have been 25 percent higher.*
>
> *The slower growth of capital stock has also meant that the economy's capacity to produce goods and services has increased more slowly in recent years relative to the earlier period.. In particular,*

manufacturing capacity growth has averaged about 2 3/4 percent per year during the present recovery, down from more than 3.5 percent in the preceding 15 years.

The persistence of large external deficits over the last six years has already done considerable damage to the long-term foundations of the economy, and the corrosive effects are now accumulating at a rapid pace...After all, a nation cannot spend more than it produces forever.

What Reaganomics, effectively, delivered in the 1980s was by no means a "supply shock" from booming investment spending, but a "demand shock" from an unprecedented escalation in personal consumer borrowing and spending. While consumption absorbed a rising share of GDP, a decreasing share went into capacity-creating investment. Moreover, as business investment shifted to shorter lived capital goods, the net capital stock grew at its lowest rate in the whole postwar period. In manufacturing it virtually stagnated. In short, economic fundamentals worsened.

Net national saving (private sector saving minus government deficits) plunged from an average rate of 7.9% of GDP in the 1970s to an average rate of 2% in the later 1980s. A declining national saving rate is equivalent to an increasing share of output that is consumed. While the budget deficit was a contributory factor, the developing consumer borrowing binge was far more important.

AND NOW THE MYTH OF THE 1990s

Observing the present exuberance about the American "new paradigm" economy, we are vividly reminded of the similar exuberance about "supply-side" Reaganomics in the 1980s. Comparing the two episodes, two parallels, in particular, strike the eye. One is the intensity of the prevailing hype, and the other is the unprecedented escalation of personal consumer borrowing and spending at the expense of savings. A prosperous country with negative savings—that's unique in economic history.

All in all, the pattern of development in the two periods is very similar, with one chief distinction: The economic and financial excesses and imbalances of the 1990s—the credit expansion relative to GDP growth, overconsumption at the expense of savings, corporate financial gearing, leveraging of securities and astronomic use of derivatives—vastly surpass the excesses of the 1980s. It is difficult to grasp the enormousness of the excesses in the financial sphere. There is leverage upon leverage as never before, manifestly made possible and propelled by two unprecedented events: unfettered global credit creation and colossal use of the computer.

Briefly back to the 1980s. Given the low capital formation, the dismal productivity performance of the 1970s essentially lingered on—until the third quarter of 1995. After three years of near-stagnation between 1992 and 1995, productivity growth all of a sudden began to spurt in that quarter. What caused that?

THE STATISTICIANS CREATE A MIRACLE

As already pointed out in the July letter, government's statisticians decided at the time that the output of computer hardware should be measured in a new way. To this end, they developed a "hedonic" price index, one designed to capture both the falling computer prices and the rapid rise of computational power of each new unit. The first result of this statistical adjustment was that in the third quarter of 1995 an increase in computer output in current dollars of $2.4 billion abruptly translated into a big increase of $14 billion in chained dollars, adding instantly 20% to real GDP growth. The coming American growth and productivity miracle of the late 1990s was born—not by policymakers but by statisticians.

For comparison: In the three-and-a-half years between end-1995 and mid-1999, computer output, measured in current dollars, rose from $65.6 billion to $104.0 billion. This paltry increase by $38.4 billion accounted for 2.4% of nominal GDP growth during this period. In short, it was a quantity not worth mentioning.

But with the magic wand of their newfangled "hedonic" price index for computers, the statisticians made a

mountain of a molehill. Ludicrously, the trivial increase in computer output in terms of current dollars metamorphosed in terms of chained dollars to the colossal amount of $391.2 billion, accounting for 36.8% of real GDP growth during this period. One stroke of the pen created the growth and productivity miracle that sent Wall Street into delirium about a "new economy."

As the production of new computer power literally exploded in the following years while their prices imploded, the share of computer output in real GDP growth has meanwhile ballooned to absurd levels. In 1996, this ratio was still 17.7%. In 1997, it virtually doubled to 33.5%, and in 1998 it surged further to 48.6% of GDP growth in chained dollars. In the first half of 1999, after all, it has zoomed to a new high of 64% of real GDP growth. With the "hedonic" price index for computers, the "new paradigm" bogus was born.

For the "new economy" mantra to make any sense, it essentially needs tangible proof by way of significantly higher productivity growth across the economy. Looking at the raw numbers, the first proof appeared with a bang in the second half of 1995. Since then, annual productivity growth in the economy as a whole has virtually doubled to 2.2%, sometimes even exceeding 3%, apparently right in step with the unfolding "investment boom" in the economy.

Is this the predicted miracle? Yes or no? Right or wrong? This is, really, the pivotal question concerning the American economy. The whole vision of the "new economy" stands or falls with the answer. Thus, it amazes us all the more how little attention economic experts, let alone among investors, pay to this all-important question. Nor can there be any excuse that the truth about productivity is very difficult to find out. As the computer component is regularly itemized within the published GDP accounts, all it needs is a simple subtraction of this figure from the GDP total. That's what we have done, as shown in the table on page 8 of the August letter. With a bit if thinking, one can easily apprehend the crucial difference between a productivity miracle occurring exclusively in the production of computers and a productivity miracle occurring across the whole economy from the use of computers.

SCIENTIFIC CORROBORATION

In recent letters, we have in detail elucidated that the higher productivity gains since 1995 have happened not across the economy as a whole but in computer manufacturing, accounting for barely 1.2% of the economy. Thanks to Internet, we have quickly got hold of the recently published study by Robert J. Gordon, a professor of economics at Northwestern University about precisely this issue. We alluded to this study briefly in the last letter. What Gordon writes boils down to a full confirmation of our own findings. Here is an excerpt from his conclusions:

> *A final conclusion is that every observer of the economy, from Business Week to Alan Greenspan, has been misled about the economy's performance by focusing on measures of prices, output, and productivity that include computers. The huge exponential growth rates of computer output, and negative growth rates of computer prices, have managed to contaminate the statistics, despite the admirable move of the BEA in 1966 to chain-weighted indexes of price and output changes.*
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> *One of the most surprising results in this paper is that the productivity performance of the manufacturing sector of the U.S. economy since 1995 has been abysmal rather than admirable. Not only has productivity growth in non-durable manufacturing decelerated in 1995-99 when compared to 1972-95, but productivity growth in durable manufacturing stripped of computers has decelerated even more. The BEA and BLS would do a great service to commentators and policymakers if they were to design as soon as possible a set of accounts of output and productivity growth, and of inflation, which refer on a consistent basis to the 98.8% of the economy engaged in activities other than the manufacture of computers.*

The following table is from this study of Prof. Robert Gordon:

PRODUCTIVITY GROWTH BY SECTOR
% INCREASE AT ANNUAL RATE

	Q2 1952-Q2 1972	Q2 1972-Q4 1995	Q4 1995-Q1 1999
NON-FARM PRIVATE BUSINESS	2.63	1.13	2.15
MANUFACTURING	2.56	2.58	4.58
DURABLES	2.32	3.05	6.78
COMPUTERS	-	17.83	41.70
NON-COMPUTERS	2.23	1.88	1.82
NON-DURABLES	2.96	2.03	2.05

Sources: US Bureau of Labor Statistics; Prof. Robert Gordon, Northwestern University

Putting it bluntly, soaring productivity growth in the manufacturing of computers explains the whole improvement in productivity growth that has taken place in the U.S. economy. In the other 99% of the economy, productivity has stalled or fallen. But since the GDP accounting simply averages the widely diverging growth rates, the recorded net result is the sudden, rapid doubling of U.S. productivity growth, purveying the false appearance that this has occurred across the entire economy. Strictly speaking, though, it is not the computer production as such which has caused this "miracle." It was the introduction of the "hedonic" price index.

SOPHISTICATED STATISTICS, LOUSY ECONOMICS

As quoted, Prof. Gordon recommends that the BEA and the BLS should design as soon as possible a set of accounts of output and productivity growth and of inflation, which refer on a consistent basis to the 98.8% of the economy engaged in activities other than the manufacture of computers. He will wait in vain for this to happen. Even if the statisticians would want to follow suit, there are vested interests in the government and on Wall Street that will never tolerate this. They will not, they cannot, and they dare not. Just imagine what will happen to stock prices if investors are officially enlightened that in 99% of the economy there has been less than zero efficiency improvement since 1995.

We assume that the statisticians who developed this "hedonic" price index for computers did so in good faith. But while it may look like sophisticated statistics, it is nevertheless lousy economics. This statistical adjustment makes no sense at all, except somebody wants to simulate strong economic growth.

In the first half of 1999, as already mentioned, computer manufacturing rose $81 billion by the measure of chained dollars, compared to an actual increase in current dollars by a paltry $6 billion. Habitually, everybody looks only at the GDP numbers in real terms. But what is the tangible economic effect of the $81 billion? In short, it is little more than zero.

From an economic perspective, this giant figure is absolutely meaningless for anybody involved in the process—for the makers as well as for the buyers of computers, and the employees, too. With the prices for their product in a free fall, the computer makers can only dream of the hundreds of billions of chained dollars which the GDP statistics have attributed to them in recent years. A rapidly shrinking fraction of these phantom dollars arrives to them as income.

Have the buyers of the computers enjoyed a rise in their current income through the steep decline of computer prices? Of course not. They have acquired an asset, the price of which is rapidly falling. Strictly speaking, this requires faster depreciation at the expense of profits. Looking for any tangible income benefit on their part from computers would essentially have to arise from efficiency gains through the use of the computers. Of that, however, there is no evidence. If you think it over, it's just ludicrous. And this is what goes for an economic miracle in the world.

INDUSTRIAL VERSUS INFORMATION REVOLUTION

The standard reply of the "new economy" adherents to such observations is that the new technology lifts

efficiency in "old line" industries, too, but more slowly and less forcefully.

In reply to the study of Prof. Gordon, *Business Week* published a commentary (Aug. 16, 1999: "The spoils of the New Economy belong to high tech"): "The classic example is the technological revolution of the late 1800s and the early 1900s. During that period the 'old economy' was agriculture, which accounted for some 35% of U.S. economic output in the 1870s. As new technologies such as the internal-combustion engine and electrification arrived, they showed up much sooner in the industrial sector than in the agricultural sector... From 1889-1929, farm productivity only rose at an annual rate of 0.9%. By contrast, manufacturing racked up 2.4% annual productivity gains over the same period. Much the same is happening today."

Comparing apples with pears, the author completely misses the key point. Think of the "Industrial Revolution" in the 1920s. The new technologies enabled and stimulated the rapid development of numerous new industries: motorcars, iron and steel, rayon and textiles, chemicals, power production, electrical equipment, etc. All this required, by the way, immense capital investments. The producers of the new capital goods became an important factor in production and employment. But, and this is the key point, this whole industrial burst arose from the spreading application of the new technologies, requiring massive investments across the whole economy.

Now compare this broad burst in economic activity in the course of the "Industrial Revolution" with the actual and potential impact of computers and the Internet on overall economic activity. They are minimal. In terms of employment, spending and income flows, actually, the computer sector is and remains a negligible quantity in the American economy around 1% of GDP. If that doubles, it is 2%. So what? In short, the idea that the Technological Revolution replaces the Industrial Revolution is ridiculous.

Nonetheless, the computer has been all-important in creating the prodigious wealth of the 1990s. However, this wealth creation has not taken place through the normal channel of revenue and profit growth from current production. No, owing to the hype that this technology created, it became America's great source of paper wealth creation through the booming stock market. This is a most important point. Not only have the high-tech firms sold their own shares at astronomic prices, even more vital has been the role of high tech in generating the hype about a "new paradigm" economy which—together with loose money and credit—is at the heart of the unprecedented wealth creation in the stock market as a whole and, in turn, at the heart of the consumer borrowing and spending binge.

THE OTHER MALAISE: PROFITS

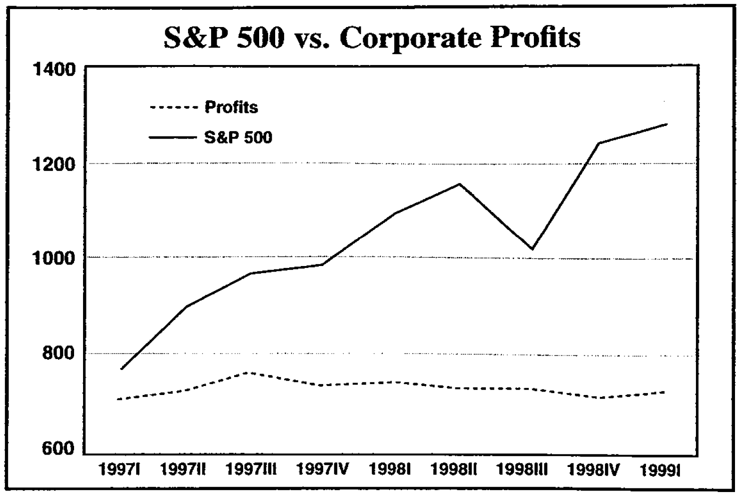
In addition, the bull market in U.S. equities did receive powerful support from unusually strong profit growth in recent years. During the four years between 1992 and 1996, profits of corporations in the non-financial sector almost doubled, implying an average annual rate of about 20%. For the bulls it was immediately a foregone conclusion that this must be the logical response to years of massive corporate restructuring, creating a developing productivity miracle.

As early as the summer of 1996, we pointed out that the sudden, steep rise in corporate earnings had nothing to do with higher productivity gains, but that this boost to earnings resulted from a sharp drop in net corporate interest expense, courtesy of Mr. Greenspan. As soon as this interest benefit ended, in 1992/94, profit growth instantly petered out, and since the third quarter of 1997 it has virtually stopped. The truth is that the profit performance in this cyclical upswing has been below normal, not above normal. See the chart on the following page.

Given "abysmal productivity growth in 99% of the American economy" (quoting Prof. Gordon), abysmal profit growth is hardly surprising. Essentially, the bulk of corporate profits has to be earned in the 99% of the economy outside the computer sector. The other 1% of the economy, the computer sector, did score fabulous productivity gains, but the plunging computer prices definitely prevented them from translating in the longer run into correspondingly stellar profits.

Meanwhile, it is common knowledge that even the disappointing reported profits are heavily manipulated

to the upside through numerous gimmicks: huge stock buybacks, stock options, write-offs and many kinds of lesser-known accounting tricks. In other words, they are generally overstated by a wide margin. Most people know, but the lucrative rise in stock prices has now continued for so long that nobody cares anymore about underlying reasons. By the way, average earnings per share for the S&P 500 are now $38.38, as against $39.54 a year ago. Still, there is permanent talk of how well profits are doing—relative to "expected profits." Which has become the customary trick to delude investors about the bleak reality in profits.



SHAREHOLDER VALUE BOGUS

Nevertheless, what is the profit outlook? Undeterred by the dismal facts, analysts simply continue to predict double-digit profit increases. As to our own opinion, we see not one reason why profits should rise, but several compelling reasons why they are sure to fall. They will do so for the very same reason that they have performed so badly in the past few years: In the 99% of the economy outside of the computer sector, there has been no productivity breakthrough. There, the widely perceived "new paradigm" revolution has never happened.

Pondering the causes of this failure, we ought to remember that Wall Street has been celebrating two revolutions in the U.S. economy: first, the high tech revolution and, second, a managerial revolution spurred by the imposition of the new corporate imperative to increase shareholder value. The concern with shareholder value is strikingly highlighted by the publicity accorded to cost-cutting through restructuring, acquisitions and mergers. But, where are the productivity and profit effects of this second revolution, the managerial revolution?

The short answer is: the absence of any measurable productivity gains in the economy as a whole essentially implies that the high-riding claims about the economic marvels arising from the shareholder value-related managerial revolution are just as hollow as those about the computer revolution. But what is the proximate cause of this failure, considering the general claim that the dealmaking mania improves efficiency? We see bogus shareholder value as the main culprit behind this failure because this obsession with higher share prices essentially tends to reinforce the chase for short-term profit gains at the expense of long-term investment.

In principle, there are two alternative ways for a corporation to raise profits. One is to expand by creating new production capacities with higher productivity levels; the other one is to put the emphasis on cutting costs in existing plant. In today's environment, the main route of expansion is dealmaking through acquisitions and mergers. Overall, however, it means corporate retreat.

Obviously, the people who propagate this strategy have never heard of what the old economists called the "fallacy of composition." It played a great role in their thinking, and it says that what may benefit a single enterprise may be damaging for the economy as a whole. Simply put: It is micro logic versus macro logic. Cutting costs and investing less in new plants can clearly be a sound device for an individual firm, but when it becomes the preponderant strategy of corporations in the whole economy, it backfires and squeezes profits overall.

We think that's what has been happening in the U.S. case. Widespread, obsessive preoccupation with higher profits in the next quarter through cost cutting is fallacious micro logic. Decreasing aggregate corporate spending reduces corporate revenue, and inherently corporate profits, overall. This doesn't imply that cost cutting is wrong. It means that it is bound to turn self-defeating when it becomes preponderant at the expense of capacity-creating new investment.

Emphasizing this point, we have to admit that we have always been highly critical of the pretentious claims of the "shareholder value" apostles about the great efficiency gains that their system is sure to bring about. To begin with, it is obvious by now that higher short-run profits are widely manufactured by creative accounting and financial engineering. Our second chief objection is that this fixation on higher stock prices essentially fosters the chase for short-term gains through cost cutting at the expense of capacity-creating long-term investment. To most managers, especially those endowed with stock options, cost cutting appeals as the easiest, least risky and also shortest way to higher profits and stock prices. But it has once-only effects, and, in the long run, it is self-defeating.

DOLLAR DANGER

Just a few weeks ago, the currency gurus around the world were still trotting out, in virtual unanimity, their claims that the euro and the yen had only one way to go against the dollar: down, down, down. Obviously, they had completely forgotten the dollar's crash last autumn, when the markets were roiled by the Asian and Russian crises. Always keep this in mind: Dollar strength is not inherent strength, it is borrowed strength.

It always was clear that once the tide in the currency markets started to turn against the dollar, it would inexorably set a self-reinforcing decline of the U.S. currency in motion. To attract the huge inflows of foreign capital which are necessary to finance the exploding trade deficit, a strong dollar is necessary. One that is suspected to be rising is even better. But by imperiling the value of existing foreign dollar investments, a falling dollar is sure to induce in addition a capital flight. Consider the dollar's collapse against the yen.

When the U.S. bubble bursts, which is only a question of time, the dollar will be prone to slide to new lows against the DM and the yen. This expectation of ours is based on two major considerations: first, the present excesses and imbalances in the U.S. bubble economy are the worst ever in history; and second, these excesses and imbalances have accumulated against the background of ballooning trade deficits and short-term foreign indebtedness. This fact critically distinguishes the present U.S. bubble from that in the late 1920s and from that in the late 1980s in Japan. At the time when those bubbles burst, both countries were the world's leading creditor and surplus nations.

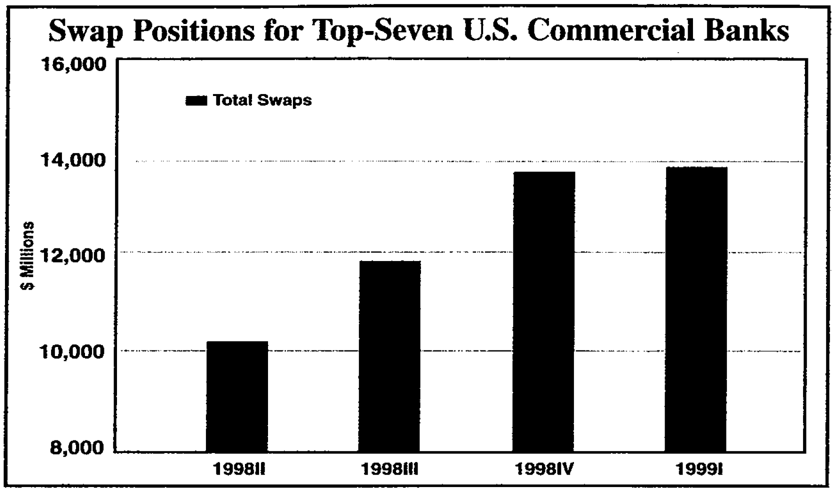
We think one cannot overstate the potential hazardous ramifications for the U.S. financial markets if dollar confidence wanes significantly. It will dramatically squeeze the already faltering liquidity in the U.S. markets, depending overwhelmingly on leverage as a source of finance. We regard it as an inescapable event. The dreadful effects of a collapsing dollar on the economies in the rest of the world need no explanation. In order to avoid the worst, the Fed may be forced drastically rise interest rates.

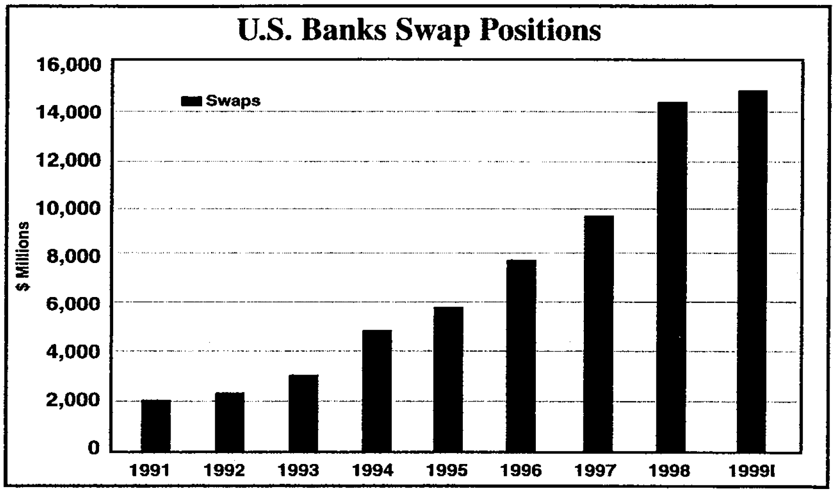
ANOTHER DANGEROUS FALLACY

Another dangerous fallacy concerns the derivatives market, another one of Wall Street's "great" achievements. In theory, it is supposed to increase the efficiency of the financial markets; in practice, it wildly stimulates speculation with the effect of gross distortions in interest rates and the prices of financial assets. That's our view. But some months ago, back in March, Mr. Greenspan shocked us with an unbelievable eulogy on the use of derivatives, calling it the "most significant event in finance during the past decade."

In essence, he said that "a vast new array of debt, equity and hybrid instruments, as well as newly crafted derivative products have fostered an unbundling of risks, which, in turn, has enabled investors to optimize (as they see it) their portfolios of financial assets. This has engendered a set of market prices and interest rates that have guided business organizations increasingly toward producing those capital investments that offer the highest long-term rates of return...This process has effectively directed scarce savings into our most potentially valuable productive capital assets. The result, especially in the United States, where financial innovations are most advanced, has been an evident acceleration in productivity and standards of living."

So much fantasy from the head of the world's leading central bank is unbelievable. If you only look at the skyrocketing *trillions of dollars* created in the derivatives markets, you realize that they imply far more speculation than hedging. According to a report issued by the Comptroller of the Currency, American commercial banks ended this year's first quarter with off-balance sheet derivative obligations of $32.7 trillion. More than 90% of these are held by the top seven institutions—Chase Manhattan, JP Morgan, Citibank, NationsBank (since merged with Bank of America), Bankers Trust (since acquired by Deutsche Bank), Bank of America and First Chicago. There is also considerable concentration by derivative type with fully $25 trillion, or about 75%, being interest rate-related instruments. Their growth has been breathtaking: from less than $4 trillion at the end of 1991 to $7.2 trillion at the end of 1993 to the $32.7 trillion today.





By the way, these numbers relate only to American banks, not to Wall Street firms. Estimates by the International Swaps and Derivative Association now have total global derivative positions—embracing outstanding interest rate swaps, currency swaps, interest rate options—at over $100 trillion. What has been going on here? Is this careful risk management, as claimed by Mr. Greenspan? Or is this leveraged financial speculation run completely amok? The astronomic size of the figures leaves no doubt in this respect.

Inarguably, derivatives played a crucial role in the proliferation of leveraged speculation in American credit markets that came to a head in the fall of 1993. When the Fed tightened in early 1994, derivatives were clearly at the center of the near disastrous unwinding of the carry trade and other leveraged speculations. The hedge fund community suffered heavy losses and even bankruptcies. The market for exotic mortgage derivative securities virtually collapsed. Many municipalities were stung by significant derivative losses as well as from sophisticated securities issued by Fannie Mae and Freddie Mac and the other government-related agencies. Higher interest rates triggered substantial losses of principal for these so-called "structured notes" with the largest casualty the taxpayers of Orange County, California.

THE TRUTH: RISK MULTIPLICATION

All the same, memories proved amazingly short-lived. Enthusiasm returned rapidly to the derivatives market. After a brief slowdown in 1995 to $1.1 trillion, they were right back in vogue with the creation of $2.3 trillion in 1996 and $3.7 trillion in 1997. This, however, is nothing compared to last year's incredible derivatives expansion, particular in the interest rate sector. These soared by $7.7 trillion, more than the total outstanding at the end of 1993.

In fact, $5 trillion of additional derivatives were created during last year's second half in the midst of the collapse in Treasury yields and the widening of credit spreads. It is certainly not just coincidental that this unprecedented derivative growth was concomitant with the greatest explosion of credit growth in history. Looking closer, we see that interest rate swaps increased $3.5 trillion during last year's second half, an annualized growth rate of 65%. By the end of this year's first quarter, they hit $14.6 trillion.

Frankly speaking, we see last year's explosive growth of new derivatives as little more than one massive Wall-Street-inspired interest rate arbitrage. Now, however, with the unwelcome surprise of sharply higher interest rates and a weakening dollar, this arbitrage is faltering badly. With the mountain of swaps and other interest derivatives being in theory the mechanism for insurance against interest rate risk, we see the great derivative fallacy coming back to haunt the derivative players. As we have explained in previous letters, derivatives can work well to reduce risk for the individual market participant, but there is absolutely no way an entire market can hedge away risk. With leveraged speculation and derivatives having become endemic to the U.S. financial market, there is no one to take the other side of the trade, when the entire market moves to "hedge."

Certainly, the banks and Wall Street firms that have written trillions of interest rate contracts didn't expect rates to rise as they have. The computer had this as a low-probability event. And certainly, Wall Street had placed great faith (understandably) that Mr. Greenspan would keep rates low...moral hazard. Obviously, money center banks and security firms do not have the wherewithal to honor huge derivative obligations if the current environment continues. The underlying concept, of course, is that in the event of sharply rising interest rates (considered most unlikely), the writers of these contracts would be able to hedge their exposure quickly by shorting Treasuries or off-load the risk to other derivative players, much like reinsurance. But the not unpredictable trouble is that liquidity has vanished across the credit markets.

The key point is that the derivatives have exactly the opposite effect than pretended and intended. In reality, consider the astronomical sums involved; they foster virtual boundless risk taking. As the sums involved multiply, the risks multiply. With $25 trillion outstanding interest rates derivatives in the case of the banks, as against the $7 trillion existing prior to 1994's market dislocations, there are, for sure, major troubles on the horizon, in particular when interest rates continue to rise. In essence, of course, losses must be matched by profits. But the losses impair the whole system.

THE DOLLAR AS CATALYST

After trading above 124 in late May, the dollar/yen has sunk to almost 110. Simultaneously, the dollar has fallen sharply against the other major currencies. Importantly, perceptions are slowly changing, and the markets begin to question the dollar's soundness. After long ignoring the atrocious U.S. trade development, the recent shocking $24.6 billion deficit triggered significant dollar selling.

Undoubtedly, the leveraged speculating community has suffered major losses from "yen carry trade." At the same time, foreign investors in America, particularly the Japanese, have been hard hit by the fall in the dollar combined with substantial declines in U.S. credit instruments. They had become heavy buyers of agency securities, especially the big, liquid issues from Fannie Mae and Freddie Mac. Caught by surprise by the falling dollar, the foreigners turned heavy sellers. Apparently, the dollar's break was much the catalyst for the rapidly widening spreads, particularly for agency debt and mortgage-back securities.

As foreigners dumped agency debt and other instruments, the highly leveraged Wall Street firms, apparently, were the only buyers. But as the dollar continued to weaken and U.S. credit market liquidity began to falter, many holders of agency paper, above all within the leveraged community, were forced to the derivatives market in a desperate attempt to hedge. This, however, only exacerbated the unfolding derivative dislocation and led to the widest swap spreads since 1987. The benchmark 10-year swap spread traded at 110. In May, it had still

traded below 70 and was only briefly above 90 during last fall's financial debacle.

Spreads also widened sharply for Fannie Mae and Freddie Mac debt instruments, and we note with interest that both institutions have sharply reduced their mortgage purchases. This was certainly a key factor behind the faltering credit market liquidity generally. Spreads for top-rates mortgage securities widened to as much as 180 basis points, up from 120 in May.

The stock market, as has become the norm, has to this point shrugged off these threatening developments. Notable broad-based weakness into mid-August was interrupted by a significant rally, likely exacerbated by derivative trading into option expiration. Nonetheless, the S&P Bank Index remains 8% below July highs. Both Fannie Mae and Freddie Mac stocks have suffered almost 20% decline from previous highs.

The technical picture of the stock market remains mixed. By the measure of the major stock indices, it still is a bull market, but by the measures of the advance-decline ratio and 52-week high-low data, it definitely looks like a bear market. The New York Stock Exchange cumulative advance-decline ratio is the result of subtracting each trading day's declining issues from that day's advancing issues. This breadth measurement, with December 1988 equaling zero, set a new lows during the August stock decline. Only 28% of all NYSE stocks and 24% of NASDAQ stocks are trading above their 1998 highs.

These figures illustrate a trouble that has been in evidence for a long time: the exceptional divergence between the narrow list of stocks helping the major averages make new highs while the overwhelming number of stocks has fallen, many very sharply. Noted technician Peter Eliades states such technical divergence is the most extraordinary since 1929.

No more consoling is what is showing up on the 52-week high-low front. For the week ended Aug. 13, there were only 248 52-week highs on the NYSE. This was 1.4% of total issues traded that week. However, the number of 52-week lows swelled to 1,106, or 6.2% of issues traded and the highest number since the dog days of last October. In the face of the poor performance of the great majority of stocks, sentiment remains extraordinarily bullish, which we do not see as a sign of market health.

THE PIERCING OF THE INTERNET/COMMUNICATIONS BUBBLE

There is now overwhelming evidence that the critical Internet bubble has been pierced. The Street.com Internet index, despite its recent rally, remains 30% below April highs. And not just the inconsequential stocks have been hammered. Industry leaders have been clobbered as well. Amazon.com has fallen 60% below highs, Yahoo 55%, eBay 70%, Priceline.com 60% and America Online 50%.

At the height of Internet stock speculation, during March-April, total margin debt had swelled $31 billion, an unprecedented increase. Recognizing that this entailed more than $60 billion of stock purchases, which we suspect were predominantly used to buy Internet stocks, losses must be immense.

The Internet mania has played a major role in the very hot IPO market. Of the more than 300 companies that have come public so far this year, about two-thirds are directly Internet business and many more closely related, the average gain on the first day was 56%. More than 60 stocks doubled. This bubble reached its crescendo in late July. During the entire month, 64 companies came to market, of which 24 were during the final week. For no obvious reason, however, sentiment faltered abruptly in early August. On Aug. 3, four new Internet IPOs fell below offering prices during the first day of trading, and it has now become commonplace for new Internet IPOs to immediately sink below offering prices. Apparently, we have witnessed the inevitable ending of Wall Street's game of "free money." Fully one third of expected deals had to be postponed.

But it is not only waning enthusiasm for new IPOs that has befallen the marketplace. Recent issues are coming under heavy selling pressure as investors dump shares and corporate management and employees alike

exercise options and liquidate shares at first opportunity, the ending of "lockup periods." With many stocks in virtual collapse, panicked insiders are seeing what they believed were great fortunes vanishing into thin air. Since April highs, the Bloomberg IPO index has declined almost 40%. Looking at the five Internet stocks with largest first-day advances this year, theglobe.com is now down 65%, Marketwatch.com 70%, Ask Jeves 50%, Healtheon 65% and Priceline.com 60%.

Remarkably, the bulls convey little anxiety regarding the Internet swoon, discarding it as an "isolated" event. With reference to the resilience of the Dow and NASDAQ's year-to-date advance, many profess only heightened. So far, their overriding response is to concentrate on fewer and fewer stock that determine the movement of the indexes In the last analysis, the strong indexes mask declining liquidity.

Inarguably, recent financial market developments are in the process of forcing a dramatic contraction in the Wall Street money spigot that has for some time provided a virtually endless flood of credit for telecom generally. Investors belatedly respond to what should have been obvious unfolding industry competitive pressures. We just don't believe one can overstate the significance of these developments. The bottom line is that few companies will escape the impending general industry slowdown.

CONCLUSIONS:

In the United States, rampant inflation is everywhere, except in the price indexes for goods and services. Excess demand is being exported. The U.S. trade deficit soared between December and June by nearly $125 billion, annual rate.

Again, the Fed softened its paltry rate hike with remarks that is should be sufficient to hold the line on inflation. The favorite explanation of Mr. Greenspan's wariness is that he's anxious about the vulnerability of the world economy. We think, his prime worry is the fragility of the U.S. financial system.

What is really taking place in the U.S. financial markets? Is the broad, sharp rise in market interest rates just a temporary overreaction to inflation fears? Certainly not. We see withdrawal symptoms from the leveraging that went to the most extreme excess in the wake of the Fed's monetary loosening last autumn.

The U.S. financial markets have become addicted to an exponential rise in leveraging. Just like the drug addict who needs ever greater doses of his drug over time to avoid withdrawal pain, the U.S. economy and its financial markets need ever greater doses of leverage to avoid liquidity problems. Credit excess essentially implies diminishing return.

If U.S. asset prices fail to rise, let alone fall, capital inflows dry up, and the dollar plunges, possibly even precipitating even outflows over time. The dollar is Mr. Greenspan's Achilles' heel.

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